

515,1624  
4/4/75

STATE OF CALIFORNIA  
BOARD OF EQUALIZATION

In the Matter of the Petition  
for Redetermination Under the  
Sales and Use Tax Law

DECISION AND RECOMMENDATION  
OF HEARING OFFICER

Account No. [REDACTED]

[REDACTED]  
Petitioner

This matter came on regularly for hearing on October 22, 1974, in San Jose, California.

Appearing for the taxpayer were [REDACTED]  
[REDACTED] Holby and Christmas appeared for the board.

Protested Item  
(Period 12/1/71 to 6/30/73)

Claimed exempt rental receipts overstated.

\$84,871

Contentions of Petitioner

Taxpayer acquired the property pursuant to an occasional sale as defined in Section 6006.5(b). Since property was taxpaid in the hands of the predecessor corporation, subsequent rental receipts would be exempt under Section 6006(g)(5), as further explained in Regulation 1660(b)(1)(E)(1).

Summary of Petition

[REDACTED] was the president of [REDACTED] account No. [REDACTED] and initially owned approximately 50 percent of the stock. He advanced money to the corporation above and beyond his initial investment, for which he received a note. As settlement for canceling the note, [REDACTED] received the equipment held by the corporation for rental purposes.

The corporation did not charge sales tax at the time of the transfer, nor did the taxpayer report the purchase on his tax return. In making the audit, the rental receipts were established as the measure of the tax on all of the equipment acquired and subsequently rented by the taxpayer.

The taxpayer contends that since a resale certificate had not been issued to the corporation, the tax should be assessed against it. If the board did this, the taxpayer would reimburse the corporation and the rental receipts would thereby be exempt.

In the alternative, the taxpayer's representative, [redacted], asserts that because of [redacted] advances of cash to the corporation that he owned over 80 percent of the corporation, although a substantial portion of his interest was represented by the outstanding note. Therefore, the exemption explained in Regulation 1660(b)(1)(E)(1) would apply. In support of the percentage of ownership, [redacted] submitted a tax return schedule for the year ending December 31, 1971, which provides:

"STATEMENT REGARDING LOSS ON [redacted]"

"During 1971, the taxpayer received the assets and assumed the liabilities of [redacted] in partial satisfaction of amounts owing the taxpayer.

"Assets received:

Tools and equipment	\$25,213
Cash	1,568
Accounts receivable	2,686
Inventory	500
Prepaid rent and deposits	302
	<u>\$30,269</u>

"Liabilities assumed 8,988

"Excess of assets over liabilities assumed \$21,281

"Balances owing taxpayer 54,171

"NON BUSINESS BAD DEBT \$32,890

"WORTHLESS SECURITIES  
Capital stock-5,520 shares \$25,675"

He also submitted numerous citations of cases involving Section 385 of the Internal Revenue Code which has a counterpart in Section 24580 of the Revenue and Taxation Code. The thrust of the argument is that where a person advances money to a corporation which is in dire financial need, that he in effect is acquiring an ownership interest rather than a creditor's interest.



Cases go both ways in this area, but they relate generally to the question of whether or not a corporation paying interest on such a note should have considered the interest payment as a dividend. In deciding this type of case, the courts look to the debt-to-equity ratio as one of the factors in determining whether or not the form used by the taxpayer should be disregarded.

In the case at hand, it is alleged that no lender would have loaned money to [redacted] in the amount loaned by [redacted]. This is based upon the fact that there was no ability of the company to pay except through profitable operations. In other words, the notes owed to [redacted] were for risk capital, and except as a preference to other shareholders, were equity capital.

In further support of this argument, [redacted] submits the following:

"Prior to the transfer, [redacted] owned 5,520 shares of stock of the Company, out of a total of 8,820 shares. [redacted] also had advanced \$58,352 to keep the Company in business. As of November 30, 1971, the Company's records indicated the following:

"Assets:

Current assets	\$ 5,055.84
Rental equipment	24,238.68
Other equipment	974.84
Total assets	<u>\$30,269.36</u>

"Liabilities and shareholders equity (deficit):

Accounts payable and other current liabilities	\$ 8,988.04
Notes payable [redacted]	58,352.54
Shareholders equity (deficit)	(37,071.22)
	<u>\$30,269.36 "</u>

Analysis and Conclusions

It appears to the hearing officer that the thrust of [redacted] argument is based upon a reverse analogy of cases involving an effort by the taxing agency to look through the form used by the taxpayer to establish liability. In the case at hand, the taxing agency (the Board) is merely accepting the taxpayer's form and asserting liability based upon the records. If we accept the taxpayer's argument, then we must accept an allegation that the taxpayer's records are incorrect, and that the form used was in error because undesirable tax consequences resulted.

[REDACTED]

If we look to the statement on the taxpayer's income tax schedule regarding the loss of (supra), it will be noted that the taxpayer took a nonbusiness bad debt loss of \$32,890. This was in addition to the capital stock write-off of \$25,675.

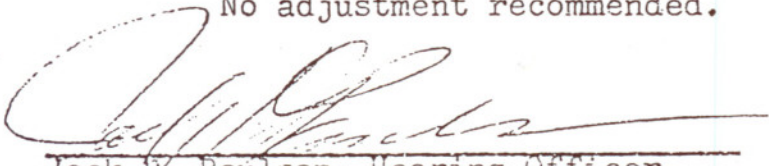
One possible reason the taxpayer did not convert the note to common stock is that the stock would have to have been entirely worthless to be used as a bad debt; whereas the note could be so used to the extent a loss was actually incurred. Other business reasons probably also existed.

In the hearing officer's opinion the taxing agency is not required to abandon the form selected and used by the taxpayer in its business affairs. To look behind the form used by a taxpayer would create almost insuperable administrative difficulties, since the board would be compelled in every transaction to look behind the documents evidencing the event and ascertain the alleged facts from extrinsic evidence. Therefore, it is concluded that the argument must fail and that tax is properly measured by rental receipts inasmuch as the taxpayer did not pay tax reimbursement to [REDACTED] or report tax measured by his purchase price at the time of acquisition.

The argument with respect to resale certificates also must fail. It is true that the board would have to look to [REDACTED] for tax on the sale if the taxpayer had not rented the property or resold it in the regular course of business prior to sale, inasmuch as [REDACTED] did not obtain a resale certificate. However, the facts of the transaction are that the sale was for resale and exempt from the definition of a retail sale under Section 6007. A resale certificate is merely evidentiary and shifts the burden to the person who issues it. Since tax liability was incurred by the purchaser by renting the property, he is responsible to the state for the tax consequences that flow therefrom.

#### Recommendation

No adjustment recommended.

  
\_\_\_\_\_  
Jack D. Paulson, Hearing Officer

Reviewed for Audit:

\_\_\_\_\_  
Principal Tax Auditor

4 April 75  
\_\_\_\_\_  
Date

\_\_\_\_\_  
Date